

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Brulte Analyst: Jane Tolman Bill Number: SB 733  
Related Bills: See Legislative History Telephone: 845-6111 Introduced Date: 06-28-2001  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Conformity/Qualified Tuition Programs

### SUMMARY

This bill would conform state law to recently enacted federal law changes with regard to the Scholarshare Program and other qualified prepaid tuition plans.

### PURPOSE OF THE BILL

The June 28, 2001 amendment added the provisions regarding the Scholarshare program that are discussed in THIS BILL below. The amendment also deleted the prior language regarding the Department of Fish and Game.

This is the department's first analysis of this bill.

### EFFECTIVE/OPERATIVE DATE

It appears that the intent of this bill is to conform state law to the changes made in federal law by the recently enacted Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16), thus, encouraging families to save for their children's college education.

### POSITION

Pending

### ANALYSIS

#### FEDERAL/STATE LAW

**Federal law** allows the taxpayer to save for their children's or grandchildren's college education in a tax deferred qualified state tuition growth program. These funds may be used for tuition and qualified expenses at any eligible university, college or trade school anywhere.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Gerald H. Goldberg

08/14/01

**State law** allows the taxpayer to participate in the Golden Gate Scholarshare Trust that offers tax deferred growth savings for the college education of the taxpayer's children or grandchildren. The funds may be used for tuition and qualified expenses at any eligible university, college, or trade school anywhere.

For a more detailed discussion of the Scholarshare Program please see Appendix A.

### THIS BILL

This bill would conform state law to the changes made to federal law by the recently enacted Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16). Like the penalty for nonqualified distributions from education IRAs, the state penalty on distributions from qualified tuition plan funds not used for qualified educational expenses would be 2½% rather than the 10% penalty under federal law.

### IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the departments programs and operations.

### TECHNICAL CONSIDERATIONS

The amendments made by P.L. 107-16 changed the labels and heading for Section 529 from "Qualified State tuition programs" to "Qualified tuition programs." Amendments 1 and 2 would delete the term state from qualified state tuition program

### **LEGISLATIVE HISTORY**

Federal Public Law 104-188 (1996), amended by Public Law 105-34 (1997), established an exemption from federal taxation for certain qualified state tuition programs (such as Scholarshare) with tax-deferred treatment of the earnings on contributions made to a qualified state tuition program.

AB 530 (Committee on Higher Education, Stats. 1997, Ch. 851) established the California Golden State Scholarshare program, which, in conformity with the federal qualified state tuition criteria, provided an exemption from state taxation for the Scholarshare program and tax deferred treatment of the earnings on contributions made to the Scholarshare program

AB 2797 (Machado, Stats. 1998, Ch. 322) allows, by direct conformity to federal provisions, an exemption from state taxation of other states' qualified state tuition programs and tax deferred treatment of the earnings on contributions made to any other state's qualified state tuition program.

### **PROGRAM BACKGROUND**

Under the Golden State Scholarshare Trust, participants open an account on behalf of a designated beneficiary. The money contributed to the account is placed in a trust that will invest in special investment portfolios chosen by the participant, which are designed to meet the needs of differently aged beneficiaries and different kinds of investors. The program is designed so that earnings in a Scholarshare Account will grow on both a federal and a state tax-deferred basis until the beneficiary is ready to go to college. The funds in the account can be used to pay for qualified higher education expenses at any eligible post-secondary institution throughout the U.S. (and even some outside the U.S.), including vocational schools.

The Scholarshare program offers four different ways for a participant to choose to invest their contributions. Three involve investments in a combination of stock, bond, and money market mutual funds. Investment returns for the equity-based and bond-based options will fluctuate and are not guaranteed since the value of accounts invested in these options will go up and down. The fourth option allocates contributions to a guaranteed funding agreement based upon the beneficiary's age that guarantees the Scholarshare Trust both a return of principal and a fixed minimum rate of return.

## **OTHER STATES' INFORMATION**

Review of *Michigan*, *Massachusetts*, and *New York* laws found similar tuition programs that allow deductions from the federal base. These states were reviewed because of the similarities between California income tax laws and their tax laws.

*Michigan* - Payments made for advance tuition contract under the Michigan Education Trust (MET) Act are deductible from federal adjusted gross income. The total purchase price of a MET contract may be deducted in the year in which a contract is purchased, and interest on the investment is not taxed until a student withdraws funds to attend college (News Release Department of Treasury, October 25, 1995). Refunds of tuition made as a result of the termination of a contract are added back to income.

*Massachusetts* - Taxpayers may take a deduction for tuition payments made to a two-or four-year college in which the taxpayer or the taxpayer's dependent is enrolled. The deduction is allowed only in the amount by which the payments exceed 25% of the taxpayer's Massachusetts adjusted gross income, exclusive of this deduction. Scholarships, grants, and other types of financial aid that are not included in Massachusetts gross income and are not required to be repaid are not considered tuition for purposes of the deduction. For tax years beginning after 2000, interest paid on loans obtained through the financial aid office of a college for undergraduate tuition and other education expenses of the taxpayer or a dependent is fully deductible. Previously, the deduction was limited to \$1,000.

*New York* - New York allows a personal income tax deduction for Family Tuition Account contributions of up to \$5,000 per year under the College Choice Tuition Savings Program. For tax years beginning after 1999, married couples filing a joint return are permitted to take a \$12,000 annual deduction without opening separate accounts.

Also applicable to such tax years, nonqualified withdrawals from a Family Tuition Account are excluded from tax to the extent that they are attributable to nondeductible contributions, i.e., contributions made to the account on an after-tax basis. Previously non-qualified distributions were subject to tax regardless of whether they represented contributions that had already been taxed.

In addition, effective October 4, 2000, Family Tuition Account owners are specifically authorized to designate another person to succeed as owner of the account in the event of the original owner's death (AB 8834, Stats. 2000, New York law.).

## **FISCAL IMPACT**

Implementing this bill would occur during the department's normal annual update.

## ECONOMIC IMPACT

### Tax Revenue Estimate

The revenue impact of this bill would be determined by the amount of distributions from all qualified tuition programs in any given year. The bill would result in the following projected revenue losses.

Estimated Revenue Impact of SB 733 As Amended 6/28/01 [\$ In Millions]				
2001-02	2002-03	2003-04	2004-05	2005-06
Negligible loss	-\$0.5	-\$1.0	-\$1.0	-\$1.5

The bill would be effective with taxable years beginning on or after January 1, 2002. Estimates were based on federal projections for this provision in the Economic Growth and Tax Relief Reconciliation Act of 2001.

## ARGUMENTS/POLICY CONCERNS

Conforming state law to federal law in this area would simplify the preparation of California tax returns for those years to which the bill's provisions apply.

## LEGISLATIVE STAFF CONTACT

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## Appendix A

**Existing federal law** provides that distributions and earnings from a state tuition program are nontaxable to the taxpayer who establishes such an account if the account meets the following criteria:

- A. Established and maintained by a state agency or instrumentality under which a person may purchase tuition credits for a designated beneficiary or make contributions to an account established to meet the qualified higher education costs of a designated beneficiary;
- B. Purchases or contributions may be made only in cash;
- C. A penalty, which is more than de minimis, is imposed on any refund of earnings from the account that is not:
  - 1. used for qualified higher education expenses of the designated beneficiary;
  - 2. made on account of the death or disability of the designated beneficiary; or
  - 3. made on account of a scholarship received by the designated beneficiary to the extent the refund does not exceed the amount of the scholarship used for qualified higher education expenses;
- D. Provides separate accounting for each designated beneficiary;
- E. Provides that contributors and beneficiaries may not, directly or indirectly, dictate the investment of any contribution to the program or earnings thereon;
- F. Does not allow interest in the program to be used as security for a loan;
- G. Prohibits contributions in excess of that necessary to provide for the qualified higher education expenses of the beneficiary, which are defined as tuition, fees, books, supplies, and equipment and reasonable costs for certain room and board; and
- H. Provides for program reporting to the Internal Revenue Service (IRS) of distributions and educational benefits received.

This **federal law** provides that the gross income of the contributor does not include earnings (at the time they are earned) under the program, and the gross income of the beneficiary does not include contributions to or earnings (at the time they are earned) from the program. However, distributions from the program in excess of amounts contributed (such as interest or dividend earnings) would be included in the gross income of the designated beneficiary at the time the distributions are made. The furnishing of education to a designated beneficiary is considered a distribution. The California Golden State Scholarshare program (discussed below) meets the criteria listed above; therefore, participants in the state Scholarshare program receive these federal tax benefits.

**Federal law** was recently amended by the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) to:

- (1) Expand the definition of a “qualified tuition program” to include tuition plans established by an educational institution, including a private institution.
- (2) Specify requirements applicable to the trustee and how the assets are to be handled by a private institution.
- (3) Repeal the more than de minimis penalty on refunds but impose a 10% tax on funds not used for higher education. This 10% tax is imposed in the same manner as the additional tax imposed on educational Individual Retirement Accounts.
- (4) Exclude from the gross income of the beneficiary recipient certain distributions made after 12/31/01.

- (5) Amend the guidelines for calculating student living expenses.
- (6) Modify the definition of “higher education expenses” to include expenses incurred by a special needs beneficiary.
- (7) Allow the beneficiary to claim the HOPE or Lifetime Learning credits.
- (8) Allow for the transfer of credits (or other amounts) from one qualified program to another for the same beneficiary.
- (9) Include first cousins in the provisions allowing credits to be transferred between family members.

**Existing state law** in the Education Code established the Golden State Scholarshare Trust. The Scholarshare Investment Board may enter into participation agreements with participants to make payments to the trust for the payment of qualified higher education expenses for a designated beneficiary to attend an institution of higher education. The program establishes an overall maximum investment level for a designated beneficiary equal to the maximum estimated qualified higher education expenses, as defined, that can be incurred by a beneficiary to obtain a baccalaureate degree at an institution of higher education in California in four years. A penalty is imposed if a participation agreement is canceled for reasons other than death or disability of the beneficiary or in the event the beneficiary receives a scholarship.

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO SB 733  
As Amended

AMENDMENT 1

On page 4, line 24 strikeout "state."

AMENDMENT 2

On page 5, line 1 strikeout "state."